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Coordinated Issue
Life Insurance Industry
Loss Utilization in a Life-Nonlife Consolidated Return
Separate v. Single Entity Approach
UIL 1503.05-00

Whether the income and losses of newly acquired nonlife members of a consolidated group can be aggregated when determining the amount of nonlife loss which may be used to offset the taxable income of life insurance companies in a life-nonlife consolidated return?

Service Position:

The loss of a nonlife member of a recently acquired group may not be aggregated with the income of another such member when determining the amount of nonlife loss which may offset life income. Each newly acquired nonlife member's individual loss must be subtracted in its entirety from the nonlife subgroup's net loss before the nonlife subgroup loss may be used to offset life members' income. See CIGNA Corporation v. Commissioner, 109 T.C. 100(1997), aff'd, 177 F.3d 136 (3rd Cir. 1999), cert. denied, 120 S.Ct. 496 (1999).

Background:

Before 1980, life insurance companies were prohibited from filing a consolidated return with nonlife companies. The Tax Reform Act of 1976, Pub.L. No. 94-455, I.R.C. § 1507, 90 Stat. 1525, 1739-1741 (1976), amended I.R.C. §§ 1504(c) and 1503(c) to provide taxpayers an election, with certain limitations, to file a consolidated return that included both life insurance companies and nonlife companies (life-nonlife consolidation) for taxable years beginning after December 31, 1980.

The limitations associated with life-nonlife consolidation include two five-year rules. The first rule provides that a life insurance company cannot join in a consolidated return with other types of companies unless it has been a "member" of the group filing the consolidated return for the preceding five taxable years. Section 1504(c)(2). To determine whether a life insurance company meets this prerequisite, the affiliation test of section 1504 is applied without regard to the general exclusion for life insurance companies provided for by section 1504(b)(2). The second five-year rule provides that losses of nonlife companies cannot be taken into account in determining the income of life insurance companies if the nonlife companies sustaining such losses have not been members of the group for at least five taxable years. Section 1503(c)(2).

Even if the limitations described above are satisfied, only a limited portion of a nonlife company's loss can be offset against the income of life insurance companies in the group. Congress limited the amount of nonlife losses which otherwise can be used to reduce life insurance income to thirty-five percent (thirty percent for 1982) of the lesser of 1) the income of the life insurance companies in the group or 2) the offsetable nonlife consolidated net operating loss. Section 1503(c)(1). This 35% limitation reflected Congress' concern that life companies, whose premium income already enjoyed tax protection under the Code, would also avoid tax on investment income by offsetting it against nonlife loss. Joint Committee on Taxation Staff, Summary of the Tax Reform Act of 1976, 94th Cong., 2d Sess. (1976), 1976-3 C.B. 448.

The legislative history underlying the section1503(c) limitations does not reflect any special consideration for members that had previously constituted their own separate affiliated group and filed their own consolidated return.

Law:

Section 1504(b)(2) provides, in part, that the term includible corporation means any corporation except insurance companies subject to taxation under § 801.

Section 1504(c)(2) provides that notwithstanding section 1504(b)(2), if an affiliated group (determined without regard to subsection (b)(2)) includes one or more domestic insurance companies taxed under section 801, the common parent of such group may elect (pursuant to regulations prescribed by the Secretary) to treat all such companies as includible corporations... except that no such company shall be so treated until it has been a member of the affiliated group for the five taxable years immediately preceding the taxable year for which the consolidated return is filed.

Section 1503(c)(2) states that the NOLs of a nonlife corporation shall not be taken into account in determining the taxable income of the life members in a life/nonlife consolidated group if such taxable year precedes the sixth taxable year such nonlife members have been members of the same affiliated group.

To determine which corporations satisfy the five year requirements of sections 1504(c) and 1503(c), the regulations adopt the concept of "eligible" and "ineligible" corporations. Treas. Reg. § 1.1502-47(d)(12) defines eligible corporations (those corporations which satisfy the five year affiliation requirements of sections1503(c) and 1504(c)), in part, as those corporations that have been members of the affiliated group for the common parent's immediately preceding five taxable years. Those corporations that do not qualify as eligible are ineligible. Treas. Reg. § 1.1502-47(d)(13).

Treas. Reg. § 1.1502-47(a)(2) provides that the consolidated taxable income of a life-nonlife group is determined by using a subgroup method.

Treas. Reg. § 1.1502-47(g)(2) provides, in part, that the consolidated taxable income of the group is the taxable income of the life subgroup set off by the nonlife subgroup losses as provided in paragraph (m).

Treas. Reg. § 1.1502-47(m)(3)(vi) provides that the offsetable nonlife consolidated net operating loss that arises in any consolidated return year (that may be set off against consolidated partial LICTI in the current taxable year or in a succeeding taxable year) is the amount computed under paragraph (h)(2)(ii) of this section [total nonlife consolidated net operating loss] reduced by the ineligible NOL. For purposes of this subparagraph (3), the "ineligible NOL" is in the year the loss arose the amount of the separate net operating loss of any nonlife member that is ineligible in that year . . . ."

Treas. Reg. § 1.1502-47(m)(4) states: "Acquired groups. [Reserved]". The accompanying preamble states:

> The Treasury Department will study further whether it is appropriate to aggregate the income and losses of ineligible members in certain cases. For instance, notwithstanding the ordinary reading of section 1503(c)(2), it may be consistent with the intent of section 1503(c)(2), or correct as a matter of policy, to aggregate the income and losses of ineligible members that filed a consolidated return prior to their acquisition by (and includibility in) another group that files a consolidated return.

Discussion:

Consistent with the restrictions of section 1503(c)(2), Treas. Reg. § 1.1502-47(h) and 1.1502-47(m)(3) generally provide that the income and losses of the nonlife members are aggregated to determine the nonlife subgroup's consolidated taxable income. If the nonlife members have, in the aggregate, a consolidated net operating loss (nonlife CNOL), the nonlife CNOL is carried back under Treas. Reg. § 1.1502-21(A)(f) or 1.1502-21T(e) (as appropriate) to offset nonlife consolidated taxable income (nonlife CTI) in a prior year before it may be used to offset life subgroup income. Treas. Reg. § 1.1502-47(h)(2)(ii). The offset of each subgroup's income and losses is an attempt to match life deductions against life income and nonlife deductions against nonlife income.

After carrying back the nonlife CNOL, the losses of the ineligible nonlife members must be subtracted from the nonlife CNOL remaining to compute the nonlife CNOL that may be used to offset life company income for the current year or in a following year. Treas. Reg. § 1.1502-47(m)(3)(vi). Losses of ineligible nonlife corporations are included in the initial calculation because there is no restriction on ineligible nonlife losses offsetting nonlife income. However, the ineligible nonlife losses must be removed in determining the amount of nonlife loss that may offset life income to enforce the section1503(c)(2) requirement that the NOLs of a nonlife corporation shall not be taken into account in determining life income.

For example, assume L, a life company, and E, an eligible nonlife subsidiary, have been filing a life-nonlife consolidated return for many years pursuant to a section 1504(c)(2) election. In 1998, L acquires S. Because S has not been a member of the L-E group for five taxable years, it is an ineligible corporation as defined by Treas. Reg. § 1.1502-47(d)(13). In 1998, L has $200 of income, E has ($100) of loss, and S has ($125) of loss. The total nonlife CNOL as defined by Treas. Reg. § 1.1502-47(h)(2)(ii) is ($100) + ($125) = ($225).

Under the general rule of Treas. Reg. § 1.1502-47(m)(3)(vi), and assuming the nonlife CNOL cannot be carried back to offset nonlife income in a prior year, the amount of nonlife CNOL that can be used to offset life income is the nonlife CNOL of ($225) reduced by the ($125) ineligible loss of S, resulting in only ($100) of offsetable nonlife loss. This is consistent with section1503(c)(2), which states that a loss of an ineligible nonlife corporation shall not be taken into account. Applying the 35% limitation of section 1503(c), L's $200 of income is offset by $35 of the nonlife loss. The remaining $190 of nonlife loss is carried forward, $125 of which remains ineligible.

The regulations do not distinguish between nonlife members acquired in separate transactions and nonlife members acquired in a single acquisition. Also, the regulations do not distinguish between losses incurred by corporations that previously filed consolidated returns and losses incurred by corporations that previously filed separate returns. Therefore, the same formula is used to determine the offsetable nonlife loss if multiple corporations are acquired or a consolidated group is acquired.

For example, L, a life company, and E, a nonlife company, have been filing a life-nonlife consolidated return pursuant to the section 1504(c)(2) election. In 1998, L acquires the S consolidated group consisting of two nonlife companies, S and S1. Because S and S1 have not been members of the group for five taxable years, they are ineligible corporations as defined by Treas. Reg. § 1.1502-47(d)(13). In 1998, L has $200 of income, E has $100 of loss, S has $200 of loss, and S1 has $75 of income. The total nonlife (CNOL) as defined by Treas. Reg. § 1.1502-47(h)(2)(ii) is ($100) + ($200) + $75 = ($225).

Under the general rule of Treas. Reg. § 1.1502-47(m)(3)(vi), the amount of nonlife CNOL that can be used to offset life income is the CNOL of $225 reduced by the $200 ineligible loss of S, resulting in only $25 of offsetable nonlife loss. In effect, S1's $75 of income is allocated entirely against E's eligible $100 loss, even though S1 is ineligible. This is consistent with section1503(c)(2), which states that ineligible loss shall not be taken into account but does not exclude consideration of income of ineligible nonlife corporations.

Because the general rule (Treas. Reg. § 1.1502-47(m)(3)(vi)) applies, the reserved section, as evidenced by the preamble, merely indicates that the Service will study the issue and may issue a specific rule in the future addressing how and if members of an acquired group should be treated differently than other corporations. However, until a special rule is provided for in the regulations, the general rule prohibits the aggregation of the income and losses of an acquired group.

A common method used by taxpayers treats the former members of the acquired consolidated group as a single economic entity after they become members of the acquiring group (i.e., as a subgroup of the acquiring group). This is accomplished by aggregating the income and losses of the former acquired group before applying Treas. Reg. § 1.1502-47(m)(3).

If this method were applied to the facts above concerning L and E's 1998 consolidated return that includes S and S1, the ineligible loss of S, $200, would be offset by the $75 income of S1, leaving an ineligible loss of only $125. This "netted" ineligible loss of the S-S1 subgroup would reduce the $225 CNOL and leave $100 of offsetable nonlife loss available to offset the $200 of life income.

The Service's position, with which the Tax Court agreed and the court of Appeals has affirmed in CIGNA, is that the regulations provide a general rule that prohibits the use of the entire amount (i.e. S's ($200)), not just a netted amount ($125), of loss of each newly acquired (ineligible) nonlife company in the 35% formula used to determine the amount of nonlife loss that can offset life income.

This entire ineligible loss of $200 would reduce the CNOL of $225 and leave only $25 of offsetable nonlife loss available to offset the $200 of life income.

Conclusion:

Each newly acquired nonlife member's individual loss must be subtracted in its entirety from the nonlife subgroup's net loss before the nonlife subgroup loss may be used to offset the life subgroup's income.